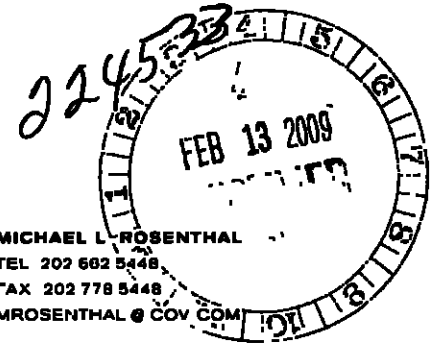


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February 13, 2009

BY HAND

The Honorable Anne K. Quinlan
Acting Secretary
Surface Transportation Board
395 E Street, SW
Washington, DC 20423

ENTERED
Office of Proceedings

FEB 13 2009

Part of
Public Record

Re STB Docket No. NOR 42111, *Oklahoma Gas and Electric
Company v. Union Pacific Railroad Company*

Dear Secretary Quinlan:

Enclosed for filing *under seal* in the above-reference matter are an original and ten copies of the CONFIDENTIAL version of Union Pacific's Reply Evidence, as well as three copies of Union Pacific's electronic workpapers (which are also CONFIDENTIAL).

We have separately enclosed for filing in the Board's *public docket* an original and ten copies of a REDACTED version of Union Pacific's Reply Evidence.

Additional paper copies of this filing are also enclosed. Please return date-stamped copies to our messenger.

Thank you for your attention to this matter.

Sincerely,

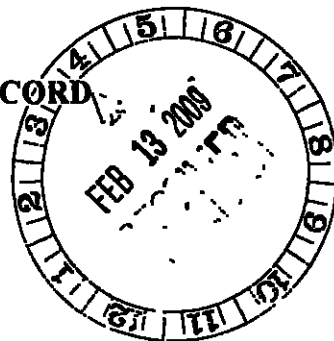
Michael I. Rosenthal

Enclosures

cc Counsel for OGE Energy Corporation

REDACTED - TO BE FILED IN THE PUBLIC RECORD

BEFORE THE
SURFACE TRANSPORTATION BOARD



OKLAHOMA GAS & ELECTRIC COMPANY,

Complainant,

v

UNION PACIFIC RAILROAD COMPANY,

Defendant

224533

Docket No 42111

UNION PACIFIC'S REPLY EVIDENCE

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February 13, 2009

OKLAHOMA GAS & ELECTRIC COMPANY,
Complainant,
v
UNION PACIFIC RAILROAD COMPANY,
Defendant

Union Pacific Railroad Company hereby submits its reply evidence in compliance
with the Board's Order served December 3, 2008

Union Pacific Railroad Company (“UP”) and Oklahoma Gas & Electric Company (“OG&E”) agree that the Board has jurisdiction to regulate the challenged rates and that it should prescribe maximum reasonable rates that equal 180 percent of UP’s variable costs for a ten-year prescription period

2

180 percent of UP's variable costs of moving that traffic, and then UP's refunding any net overpayments to OG&E, or OG&E's paying any net underpayments to UP, with interest on the net amount owed

However, UP and OG&E disagree about two issues

First, the parties disagree about how and when to perform the true-up calculation. UP believes that the parties should perform the true-up after they have data concerning both UP's actual operating characteristics and UP's actual URCS costs for the period in which the traffic moved. By contrast, OG&E would use indexed URCS costs from a prior period, rather than actual URCS costs for the period in which the traffic moved, to perform the true-up. In addition, it appears that OG&E would use actual operating characteristics from only the second quarter through the fourth quarter of each year, thus disregarding movements from the first quarter of each year, to perform the true-up.

Second, the parties disagree about whether the Board should prescribe specific "interim rates" – that is, temporary rates subject to a later true-up – for 2009 and each subsequent year of the prescription period, and if so, how to establish those rates. UP believes that it should be allowed to set its rates in the first instance because any under-payment over-payment would be addressed in the true-up calculation. By contrast, OG&E asks the Board to prescribe rates for 2009 based on a novel, untested forecasting methodology, and then prescribe "Annual Effective Rates" for each subsequent year using a methodology that could not be implemented until the second quarter of each year.

We believe that UP's approach is superior for the reasons discussed below.

A. The "True-Up" Calculation

OG&E correctly recognizes that any award requiring UP to charge rates that yield revenues equal to 180 percent of UP's variable costs and to pay reparations for any portion of the

transportation charges that exceeds 180 percent of UP's variable costs must also provide for a true-up calculation. A true-up calculation is necessary because there can be no guarantee that the rates UP charges OG&E in any year will actually equal 180 percent of UP's variable costs, no matter how the rates are established. There can be no such guarantee because UP's variable costs for each year cannot be calculated accurately without knowing (i) the traffic's actual operating characteristics, and (ii) UP's URCS costs for the period in which that traffic moved.

OG&E proposes a true-up calculation, but its proposal is flawed because it does not fully account for either source of the time-lag problem. First, with respect to the need to know the traffic's actual operating characteristics, OG&E's proposal only takes into account the actual operating characteristics for the last three quarters of each year. OG&E Op II-A-7, Step 2 ("The parties will exchange their calculations of quarterly operating characteristics and variable costs for 2Q 2009 through 4Q 2009.") Second, OG&E's proposal does not ensure that UP's variable costs of handling the issue traffic are calculated using UP's actual URCS costs for the period in which the traffic moved. Instead, it relies on indexing the prior year's URCS costs. OG&E Op II-A-7 to II-A-8, Steps 1 & 3.

OG&E's proposed use of indexed URCS costs rather than UP's actual URCS costs is especially problematic. Predicting a rail carrier's URCS costs for any year by indexing the prior year's URCS costs is a process fraught with uncertainty. This is especially true of OG&E's proposed process. OG&E would index UP's URCS costs using cost data that do not specifically reflect the cost changes experienced by UP – OG&E proposes to use a combination of Association of American Railroads ("AAR") and Bureau of Labor Statistics ("BLS") indices. *Id.* However, UP's costs likely will have increased or decreased by more (or less) than the broad industry averages reflected in those indices. Moreover, UP's URCS costs will change from year-

to-year not only based on changing input costs, but also based on the railroad's operating performance – that is, how many assets UP uses to produce an ever-changing mix of transportation services

Mark Draper, UP's witness on costing issues, has prepared a workpaper that illustrates the potentially significant problem with relying on indexed URCS costs rather than actual URCS costs. He developed UP's variable costs for handling a hypothetical movement of coal from Antelope Mine in the Powder River Basin to the Muskogee Electric Generating Station first with UP's 2006 URCS costs indexed to 2007 levels (using the method proposed by OG&E), and then with UP's actual 2007 URCS costs. Mr. Draper's calculations show that using actual 2007 URCS costs, rather than indexed 2006 URCS costs, increases the 180 percent jurisdictional threshold by approximately \$0.68 per ton.¹ OG&E's Muskogee Station consumes approximately 6 million tons of coal each year, so the difference between the two approaches would translate into more than \$4.0 million of revenue in just a single year. UP respectfully submits that the difference is too large to ignore, but it would be ignored under the approach proposed by OG&E.

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¹ See Reply electronic workpaper "Antelope Indexed URCS 2006 vs 2007.xls."

² Bracketed material has been redacted from the public version of UP's Reply Evidence.

In short, OG&E's proposal essentially guarantees that each annual true-up calculation will create either an overcharge or undercharge, representing the difference between UP's indexed URCS costs from a prior year and its actual URCS costs from the year in which the traffic moved. OG&E may be willing to accept the possibility that it will not receive the full benefit of a rate prescription. However, UP is not willing to accept the possibility that it will be required to collect less than 180 percent of its variable costs, and the Board does not have the authority to impose that result. See *West Tex Utils Co v Burlington N R R*, 1 S T B 638, 677 (1996), *Tex Mun Power Agency v Burlington N & Santa Fe Ry*, STB Docket No. 42056, slip op. at 29 (STB served Sept. 27, 2004).³

Accordingly, if the Board addresses the need for a true-up calculation, UP urges the Board to establish a process that accounts for both UP's actual operating characteristics and UP's actual URCS costs for the period in which the traffic moved.

B. Rate Prescription

UP strongly disagrees with OG&E's proposal for establishing specific "Annual Effective Rates" for the issue traffic in 2009 (or any other year during the ten-year prescription period). Board precedent establishes that the agency cannot and will not prescribe specific rates for future movements because it and the parties lack the necessary information to calculate the variable costs for those movements. See *Kansas City Power & Light Co v Union Pac R R*, STB Docket No. 42095, slip op. at 9 (STB served May 19, 2008), see also *Wisconsin Power & Light Co v Union Pac R R*, 5 S T B 955, 985 n.84 (2001). OG&E offers no reason to treat

³ UP recognizes that OG&E might propose a second true-up, after UP's actual URCS costs become available, but that would just add another potentially costly step in the process and another opportunity for disputes to arise. UP's approach requires just one true up that would occur once the necessary information becomes available.

this case differently from any other case⁴ The Board should order UP to establish, and OG&E to pay, common carrier rates that yield revenues equal to 180 percent of UP's variable costs, and the Board should remain available to resolve any disputes See, e g , *Kansas City Power & Light*, slip op at 9-10, *Tex Mun Power Agency*, slip op at 28

UP believes that the Board should simply order (i) UP to establish, and OG&E to pay, common carrier rates that yield revenues equal to 180 percent of UP's variable costs, and (ii) UP to pay OG&E reparations for any portion of the transportation charges collected by UP that exceeds 180 percent of UP's variable costs, together with interest (subject to a true-up calculation) UP Op at 3-5, see also *Kansas City Power & Light Co* , slip op at 9-10

UP's approach would allow UP to attempt to set rates at 180 percent of variable costs in the first instance, and then allow the parties to use UP's actual operating characteristics and URCS cost data to ensure that OG&E never ends up paying more than 180 percent of UP's variable costs UP's approach is consistent with Board precedent, including the fundamental principle that rail carriers should be allowed to establish their rates in the first instance because shippers can obtain reparations with interest if their rates are found to be unreasonably high See, e g , *Burlington Northern, Inc v United States*, 459 U S 131, 141-42 (1982), *Seminole Elec Coop v CSX Transp , Inc* , STB Docket No 42110 (STB served Dec 22, 2008), at 3

Even if the Board were to depart from precedent and establish a procedure for prescribing "interim rates" – that is, temporary rates subject to a later true-up – it should not

⁴ UP and OG&E agreed that the Board should calculate the jurisdictional threshold for purposes of determining its jurisdiction based on the traffic and operating characteristics of OG&E traffic that moved from November 1, 2007 through October 31, 2008 See Joint Stipulation and Report on the Parties' Conference Pursuant to 49 C F R § 1111.10(b), filed November 21, 2008, cf *Tex Mun Power Agency*, slip op at 28 (Board can make market dominance determination even in the absence of actual movements under the challenged rate) However, UP did not agree to use those data to prescribe rates for future movements

adopt the procedure proposed by OG&E. OG&E's proposal has two significant flaws. First, OG&E proposes to use a novel, untested methodology to index UP's 2007 URCS in order to establish rates for 2009. Second, OG&E would establish "Annual Effective Rates" for the remaining years in the ten-year prescription period using a methodology that could not be implemented until the second quarter of each year (and that would apparently disregard the actual operating characteristics of movements in the first quarter of each year). OG&E Op II-A-7 to II-A-8.⁵

If the Board were to prescribe interim rates, it should require the parties to use a procedure that relies on established methodologies and that would allow the parties to calculate an interim rate that could be implemented each year on January 1. Specifically, the Board should require the parties to

1. Start with the agreed-upon Phase III traffic and operating characteristics, which reflect OG&E traffic that moved from November 1, 2007 through October 31, 2008.

2. Estimate UP's variable costs by indexing UP's 2007 URCS to 2009 levels using established indices. Specifically, the parties should index the 2007 URCS to third-quarter 2008 levels using the same AAR and BLS indices the Board uses when indexing URCS on a quarterly basis.⁶ Because AAR and BLS fourth-quarter indices would not be available early enough for the parties to use them in establishing rates for the first quarter of the subsequent year, the parties should index third-quarter cost levels for one year to first-quarter cost levels for the next year using the RCAF-U – the only Board-accepted, forward-looking cost index that is

⁵ OG&E incorrectly claims that the Board's rate prescription would expire in 2019. OG&E Op II-A-8. In fact, the ten-year period would expire at the end of 2018.

⁶ See 49 U.S.C. § 10707(d)(1)(B), *see also Wisconsin Power & Light*, 5 S.F.B. at 1005.

available before the end of the calendar year. The result would be the interim rate for the first quarter of 2009.

3 Repeat the process each year with more recent data to calculate the interim rate for the remaining years of the rate prescription. For example, the interim rates for 2010 would be calculated by indexing UP's 2008 URCS costs to first-quarter 2010 levels and applying those costs to the actual operating characteristics of OG&E traffic from November 1, 2008 through October 31, 2009.

4 A true-up process would be conducted for 2009 movements after UP's 2009 URCS costs are available, and those URCS costs would be applied to actual 2009 operating characteristics to determine the prescribed rates. The difference between the interim rates and the prescribed rates for the issue traffic would be calculated, and the net difference and interest would be paid by UP if there was an overpayment and would be paid by OG&E if there was an underpayment. The true-up process would be repeated for each year in the prescription period.

OG&E's proposal is similar in concept, but the differences in the variable cost information that would be used are significant. First, OG&E does not rely on Board's standard indexing procedure and its RCAF-U calculation to estimate UP's 2009 variable costs. Instead, it has developed a novel procedure that jumps in a single step from UP's 2007 URCS costs to an estimate of UP's 2009 URCS costs by "predicting" the results of the Board's standard indexing procedure before the actual data are available. OG&E Op II-A-5 to II-A-6. OG&E thus uses some portions of the forecasts developed for the RCAF-U, but for unexplained reasons, it supplements them with forecasts developed by the Energy Information Administration. *Id.*, II-A-6. This mix-and-match approach is unnecessary, complicated, and highly suspect in light of available, established alternatives.

OG&E appears to recognize the questionable nature of its proposal. For each year after 2009, OG&E would have the Board use its standard URCS indexing procedure rather than the mix-and-match approach it proposes to use for 2009. OG&E's post-2009 approach is also problematic, however, because new rates could not be put in place until the second quarter of each year – when first quarter AAR and BLS data become available. As a result, UP's first quarter rates would always lag behind changing costs. Moreover, OG&E's proposed approach requires the parties to disregard actual operating characteristics from the first quarter of each year.

The Board should adhere to precedent and not require UP to establish any specific interim rates. However, if the Board does depart from precedent, it should require the parties to use a procedure that can be applied consistently across the entire prescription period and that attempts to reflect current costs.

II. MARKET DOMINANCE

A. QUANTITATIVE EVIDENCE.

UP and OG&E agree that the Board has jurisdiction over the movements covered by OG&E's Complaint. The differences in the parties' jurisdictional threshold calculations are explained by two factors. First, apparently as a result of a programming error, UP's workpapers contained data that do not correctly reflect the data in UP's Form R-1. Second, UP and OG&E used different methods of indexing UP's 2007 URCS to estimate UP's URCS costs for the first quarter of 2009 ("1Q09").

Neither issue affects the parties' conclusion that the Board has jurisdiction over the challenged rates. However, the indexing issue merits some additional discussion because OG&E has proposed to use those calculations as the basis for prescribing UP rates for 2009.

The challenged rates apply to movements that began in January 2009. UP and OG&E understood that, to determine whether the Board has jurisdiction over the challenged rates, they had to approximate UP's variable costs for 1Q09. They had to approximate UP's variable costs for 1Q09 because UP's actual URCS costs are available only through 2007.

UP estimated 1Q09 URCS costs in a two-step process that relied on established methodologies for each step. First, UP used the same AAR and BLS indices that the Board uses to index URCS costs on a quarterly basis in order to project UP's 2007 URCS costs forward to the fourth quarter of 2008. Second, because those indices were not yet available for 1Q09, UP used the Board's RCAF-U calculation to project fourth-quarter 2008 estimate forward to 2009. UP relied on RCAF-U as the only Board-accepted, forward-looking cost index that is available.

OG&E, by contrast, estimated UP's 1Q09 URCS costs in one step, by relying on a mix of several sources, including portions of the RCAF and a forecast prepared by the EIA, to predict the results that would be generated by the AAR and BLS indices in 1Q09. OG&E Op. II-A-5 to II-A-6.⁷

UP believes that its methodology is superior because it uses accepted methods of indexing, rather than an untested, novel approach to predicting the results of the Board's standard indexing process – in effect, a prediction of a prediction. Thus, if the Board does adopt OG&E's general proposal to prescribe interim rates, the Board should model its specific approach on UP's methodology. The only difference would be that the parties would have to use RCAF-U data to index UP's costs from third-quarter 2008 levels to 1Q09 levels, rather than from fourth-quarter 2008 levels to 1Q09 levels, because the AAR and BLS data needed to index UP's costs from the

⁷ OG&E's exhibits use a slightly different figure to index UP's 2007 URCS costs to 1Q09 cost levels than OG&E's electronic workpapers, but the reasons for the discrepancy are unclear.

third to the fourth quarter do not become available until 1Q09. A sample calculation for Antelope Mine is included in UP's workpapers.⁸

However, UP believes that the Board should not adopt an approach that relies on indexing to prescribe rates. The disparity in results created by UP's and OG&E's disagreement over how to index UP's 2007 URCS costs to 1Q09 cost levels helps demonstrate some of the perils of indexing. However, using indexing to predict the future cost levels is a perilous exercise even when the parties agree on the indexing methodology.

Mr. Draper's workpapers demonstrate the potentially significant problem with relying on indexed URCS costs rather than actual URCS costs. To illustrate the hazards of using indexed URCS costs, Mr. Draper calculated UP's cost to handle a hypothetical movement of coal from Antelope Mine in the Powder River Basin to OG&E's Muskogee Electric Generating Station. Mr. Draper used the parties' agreed-upon operating characteristics for Antelope Mine movements, and then he used the Board's Phase III URCS program to calculate UP's 2007 URCS costs in two different ways. First, Mr. Draper used UP's 2006 URCS costs, indexed to 2007 levels using the Board's indexing method. Second, Mr. Draper used UP's actual 2007 URCS costs – the most recent year for which UP's actual URCS costs are available.⁹

The results of Mr. Draper's calculations are striking. Using UP's actual 2007 URCS costs, rather than indexed 2006 URCS costs, increases the jurisdictional threshold by

⁸ See Reply electronic workpapers "Antelope 1Q09 alternative rate calculation rr cars.xls" and "Antelope 1Q09 alternative rate calculation private cars.xls." Interim rates for other issue movements could readily be calculated by multiplying the variable cost per ton at the 2007 URCS level shown in UP's opening evidence by the same factor used to index the Antelope Mine rates to 1Q09 levels in the sample calculation, namely 1.9404. See Opening electronic workpapers "Threshold analysis rr cars.xls" and "Threshold analysis private cars.xls."

⁹ See Reply electronic workpaper "Antelope Indexed URCS 2006 vs 2007.xls."

approximately \$0.68 per ton. Calculations from other Powder River Basin mines would produce approximately the same result because all of OG&E's coal shipments have similar operating characteristics. To put this result into perspective, Muskogee Station burns approximately 6 million tons of coal each year, so the difference between using UP's actual costs and using UP's indexed costs would translate into more than \$4.0 million of revenue in just one year. Such a disparity could occur in the opposite direction as well.

Mr. Draper notes that results may be striking, but they are not unexpected. Even the Board's standard indexing process, which OG&E proposes to use to set interim rates after 2009, relies on cost data that do not specifically reflect cost changes experienced by UP. UP's costs likely will have increased or decreased by more (or less) than the broad industry averages reflected in the indices developed by the AAR and the BLS. Moreover, a railroad's URCS costs are not constant from year to year – they change based on the railroad's volume, traffic mix, and operating performance. One needs both halves of the puzzle to calculate URCS costs accurately, and the information is not available until the Board produces each year's URCS application.

Respectfully submitted,



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Attorneys for Union Pacific Railroad Company

February 13, 2009

CERTIFICATE OF SERVICE

I, Michael L. Rosenthal, certify that on this 13th day of February, 2009, I caused a copy of Union Pacific's Reply Evidence to be served by hand on

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and by first-class mail, postage prepaid, on

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Michael L. Rosenthal

IV WITNESS QUALIFICATIONS AND VERIFICATIONS

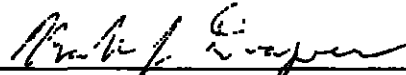
A. Mark J. Draper

Mark J Draper is Manager – Economic Research and Analysis for Union Pacific Railroad Company. His office is located at 1400 Douglas Street, Omaha, Nebraska, 68179. Mr. Draper is responsible for, among other things, Union Pacific's regulatory costing efforts. Mr. Draper has worked in Union Pacific's Finance Department for nearly 29 years.

Mr. Draper is sponsoring evidence relating to Union Pacific's variable costs for the issue movements. His evidence is incorporated in Section II A of the Narrative. Mr. Draper has signed a verification of the truth of the statements contained therein. A copy of Mr. Draper's verification is attached hereto.

I declare under penalty of perjury that I have read the Reply Evidence that I have sponsored, as described in the foregoing Statement of Qualifications, and that the contents thereof are true and correct Further, I certify that I am qualified and authorized to sponsor this testimony

Executed on February 13, 2009


Mark. J. Draper